

Asian Securities Analysts Federation Position Paper 2003:

Recommendations for Addressing Conflicts of Interest in Securities Analyst Research

- A. INTRODUCTION: CONFLICTS OF INTEREST IN SECURITIES ANALYST RESEARCH

- B. RECOMMENDED PRINCIPLES FOR MANAGING RESEARCH CONFLICTS OF INTEREST IN PRACTICE
 - 1. Place the Interests of Investors First
 - 2. Internal Management Arrangements
 - (a) Separate and Distinct Reporting Structures:
 - (b) Internal Chinese Walls to Prevent Dissemination of Information:
 - (c) Internal Review and Approval of Research:
 - (d) Analyst Compensation and Reward Structure:
 - (e) Statement of Firm's Policies and Procedures:
 - (f) Monitor Compliance with Firm's Policies and Procedures:
 - 3. Content of Research Recommendations: Unambiguous, Consistent and Transparent
 - 4. Disclosure of Interests
 - 5. Dissemination of Research
 - 6. Restrictions on Personal Account Dealing and Trading by Analyst
 - 7. External Pressure from Issuer

ASAF Position Paper
Addressing Conflicts of Interest in Securities Analyst Research

A. INTRODUCTION: CONFLICTS OF INTEREST IN SECURITIES ANALYST RESEARCH

The principal issue addressed by the Asian Securities Analysts Federation (ASAF) Advocacy Committee in 2003 has been Analyst Research, specifically recommendations for best practice for addressing analyst conflicts of interest and for ensuring and enhancing research independence, objectivity and integrity.

Based on contributions received from ASAF member societies on the existing research policies and procedures operating in their country/region, the ASAF Advocacy Committee has developed the following position for consideration, *Recommendations for Addressing Conflicts of Interest in Securities Analyst Research*.

In line with increasing industry and market concerns and relevant policy proposals for addressing analyst independence and research objectivity issues developed in major capital markets and in keeping with ASAF's commitment to raising standards of professional conduct, this position paper presents a conceptual framework that focuses on factors that may threaten research objectivity and suggests various safeguards that analysts and stockbroking firms with a research function should implement to ensure the quality, objectivity and independence of their investment research reports and recommendations.

The analyst's role is to promote market efficiency by gathering and analysing information and providing valuable insights on companies and industry trends. However, where both research and other corporate finance/investment banking services are offered within the analyst's firm, the symbiotic relationship that exists between these activities has the potential to give rise to conflicts of interests which, if not properly addressed, may unduly or improperly influence and impair research objectivity and adversely affect investor confidence in the integrity of the market.

The main areas identified as being of particular concern include management supervision and blurred reporting lines and accountability for analysts and the research function, analyst involvement in a firm's investment banking and equity sales and trading, analyst compensation and reward structures, current or potential relationships between a corporate issuer and the firm's investment banking division and the exposure of an analyst or the firm to a corporate issuer's securities.

This position paper has been developed to assist analysts and their firms in addressing and managing those conflicts of interest that may affect and influence the quality, independence and objectivity of research reports and recommendations.

Given that the approach to research and conflict management may vary from firm to firm and that many established research practices are being reassessed in view of the changing investment environment, these recommendations present high-level principles of general application. They aim to encourage a simple best practice approach to analyst research and to foster a strong culture of research independence, objectivity and integrity that clearly puts the interests of investors before either the stockbroking firm's or individual analyst's own interests.

This paper is based on the premise that a principles-based approach focusing on acceptable standards of professional conduct will provide the most appropriate broad framework for addressing conflicts of interest. The approach adopted is that imposing detailed, prescriptive rules on research departments will not produce the best outcome and that conflicts of interest are best addressed through a combination of tight internal management control and effective disclosure to the market.

The practical principles recommended have been formulated to enable broking firms with a research function to adopt the suggested practices flexibly and sensibly to meet legal requirements and local market conditions and their particular business needs and

ASAF Position Paper
Addressing Conflicts of Interest in Securities Analyst Research

circumstances. They are not intended to change or supplant an analyst's or broking firm's obligations under the applicable local regulatory system, under industry guidelines or internal policies, procedures and structures in relation to producing investment research.

The ASAF Advocacy Committee encourages ASAF member societies to promote and advocate these recommendations governing professional conduct in performing securities research and analysis to the broking firms, securities analysts, corporate issuers and regulatory authorities in their respective markets.

ASAF Position Paper
Addressing Conflicts of Interest in Securities Analyst Research

B. RECOMMENDED PRINCIPLES FOR MANAGING RESEARCH CONFLICTS OF INTEREST IN PRACTICE

The recommended approach is to focus on the management, control and disclosure of conflicts of interest that could prevent a firm's investment research from meeting requirements for factual and objective research and to provide guidance on how to handle the conflicts of interest inherent in producing research recommendations.

Where appropriate, this paper presents examples of practices that would or would not be acceptable.

1. Place the Interests of Investors First

Principle:

Analysts and their firms have a fundamental duty to put the interests of investors first and should not allow this primary duty to be influenced by their own interests or the interests of their firm.

Commentary and guidance:

Any conflicts of interest should be managed fairly in the interests of the firm's clients.

In producing research for publication, analysts must consider who is the client, to whom they owe a fiduciary duty. Usually, the clients will be existing or potential investors of the subject company's securities.

2. Internal Management Arrangements

Principle:

To enable a securities analyst to conduct objective and fair analysis, the broking firm to which the analyst belongs should provide a suitable working environment that facilitates and ensures the production of objective quality investment research.

Commentary and guidance:

The internal systems and controls established by the firm should be sufficiently robust and consistent enough to deliver effective conflict management in practice.

It is paramount that a broking firm acts responsibly to ensure that their analysts are as free as possible from conflicts of interest that could improperly influence the content of their work and could impair their ability to produce objective research.

It falls within the responsibility of each firm's senior management to ensure that conflicts of interest are identified and managed, to put in place appropriate internal systems, procedures and controls designed to address potential or actual conflicts of interest and to ensure they are effective in practice. If not done, the ability to act in the best interests of their clients may be seriously compromised, whether those clients are institutional or retail investors.

Although what constitutes appropriate systems and controls will vary as it is a matter of judgment for each firm's senior management, the following internal structures and arrangements should be established.

(a) Separate and Distinct Reporting Structures:

Where an analyst's firm offers both research and other corporate finance/investment banking or trading services, it should provide separate and distinct reporting structures to ensure that the integrity of research and investment recommendations is not compromised.

Reporting lines, management and accountability structures should protect and insulate research analyst work from influence from other divisions of the firm. A firm should have appropriately robust systems and controls in place to ensure that the firm's own interests do not improperly influence the content of research reports and recommendations produced by their analysts.

As a minimum, the reporting lines and accountability structures should ensure that decisions on what stocks are covered, what is written and when it is published are not subject to management control by the investment banking or equity sales and trading divisions of the firm.

ASAF Position Paper
Addressing Conflicts of Interest in Securities Analyst Research

(b) Internal Chinese Walls to Prevent Dissemination of Information:

Firms offering both research and other corporate or trading services should have in place a well-defined Chinese walls policy that prohibits direct communication and dissemination of confidential information between analysts and these other divisions which may compromise the integrity of the research reports or recommendations produced.

Firms should formulate and implement Chinese Walls compliance policies and procedures to protect both the confidentiality of investment banking clients' information and to ensure the research analyst remains objective and independent, basing their research on their own interpretative analysis and on publicly known facts and information.

Although it is acknowledged that analysts may have knowledge and expertise of general or specific use to other divisions of the firm and to their investment clients, a firm's decision to take an analyst 'over the wall' must be carefully considered and tightly controlled at all times.

It would be acceptable for the broking firm to draw on the analyst's knowledge and skills to research investment banking opportunities; to provide ideas to the equity sales and trading divisions; or to provide supporting market information and advice to the firm's investment clients.

It would be unacceptable for analysts to be involved either in pitches for new investment banking mandates or in active marketing of new corporate issues (eg: in roadshows), whether by issuing research recommendations or being involved in equity advice or sales to clients.

(c) Internal Review and Approval of Research:

Prior to publication, an analyst should not be permitted to submit research reports or investment recommendations to the firm's internal corporate finance, investment banking, dealing or trading divisions for their review or approval.

Staff involved in investment banking or equity sales and trading activities should not be permitted to vet or approve an analyst's draft research report before publication.

An analyst may provide selected draft research to an internal division of the firm outside the research function for the sole limited purpose of verifying facts only (or correcting any factual inaccuracy) in relation to a particular corporate issuer's securities, provided that draft research copy contains no details of proposed recommendations, ratings, price targets, earnings projections or revenue forecast.

(d) Analyst Compensation and Reward Structure:

Firms should avoid compensation and reward structures that create direct incentives for analysts to act in ways that would potentially compromise their judgment.

An analyst's remuneration should be a reflection of the individual analyst's overall performance, including the performance of their research and investment recommendations.

An analyst's remuneration should not be directly linked to revenue received through corporate finance/investment banking activities in which the analyst has been involved.

It would be acceptable to relate an analyst's pay and benefits to the general profits of the firm, subject to generally agreed measures of performance.

It would be unacceptable to base an analyst's pay and benefits on the analyst's contribution to profits on specific investment banking deals; or to be determined by managers of the investment banking or equity sales and trading divisions.

(e) Statement of Firm's Policies and Procedures:

Each firm should produce a detailed written document outlining its internal policies and procedures for managing potential conflicts of interest that may influence the integrity of research and investment recommendations.

Such internal policies and procedures might set out recordkeeping requirements for research document creation, amendment, retention and destruction, research distribution requirements and restrictions, disclosure requirements, staff trading restrictions and permitted involvement

ASAF Position Paper
Addressing Conflicts of Interest in Securities Analyst Research

in activities outside the research function. To ensure their continuing relevance and effectiveness, the firm should review these policies and procedures on a regular basis.

A firm's internal statement of policies and procedures for research and conflict management should be made freely available to any investor on request.

(f) Monitor Compliance with Firm's Policies and Procedures:

Each firm should monitor staff compliance with their internal policies and procedures for managing potential conflicts of interest that may influence the integrity of research and investment recommendations.

3. Content of Research Recommendations: Unambiguous, Consistent and Transparent

Principle:

Research reports and recommendations produced by analysts should be unambiguous, consistent and transparent. As independent and objective observers of the companies they cover, an analyst should have a reasonable basis, supported by proper research and analysis, for any investor recommendations they make.

Commentary and guidance:

An analyst must exercise diligence and thoroughness in performing research analysis and issue independent recommendations based solely on their own analysis, supported by appropriate and current research and investigation.

In research reports and recommendations, the data based on which analysis is made must be accurate and the source(s) identifiable, the analytical methods employed by the analyst must be rational and the process leading to the conclusion or recommendation must be clear. Any summary of a research report should accurately represent the points in the main body of the full report.

To help investors understand the significance of a research report or recommendation, it is recommended that the analyst should clearly indicate the clients for whom the research is principally intended; distinguish fact from opinion or estimates, reference sources of data used, avoid using overly technical terminology, jargon or abbreviations that only an expert would understand, record the date when the research was first released and explain the characteristics of the subject investment including risk factors.

4. Disclosure of Interests

Principle:

Analysts and their firms should make clear disclosure of any financial interest or any current or prospective relationship between the analyst, the firm and the subject corporate issuer that could compromise the objectivity of the research produced.

Commentary and guidance:

In making a disclosure of interests relevant to the research analysis, analysts and their firms should aim to improve an investor's understanding both of the research itself and of the conflicts of interest which may lie behind its production. Disclosure of related interests should place the investor in a better position to determine what value to attach to a research report's content and recommendations.

Disclosure of interests should focus on the actual and potential conflicts of interest and should provide sufficient detail of the specific relevant interest related to the subject research to enable fair presentation and interpretation of the research findings.

Disclosure of interest requirements in research reports or recommendations should be seen as a responsible measure to ensure research independence – however, it does not relieve an analyst or their firm from their duty to manage their conflicts of interest effectively and fairly in the interests of their clients.

ASAF Position Paper

Addressing Conflicts of Interest in Securities Analyst Research

As best practice, a research report or investment recommendation should disclose:

- whether the analyst has any financial or beneficial interest in the securities of the subject corporate issuer featured in the research and which may influence the research published;
- whether any compensation or other benefit in connection with the research report or recommendation was received by the analyst or stockbroking firm from the subject issuer featured in the research;
- whether the stockbroking firm had any investment banking mandates or managed any issue of securities or transaction involving a fee payment for the subject corporate issuer during the previous 12 months;
- whether the stockbroking firm currently makes a market in the securities of the subject corporate issuer;
- whether the stockbroking firm has a shareholding in the subject corporate issuer or whether the issuer covered has a shareholding in the stockbroking firm;
- a list of definitions of the terms used in the research recommendations and, if applicable, the risk factors identified and the currency or investment time horizon of the recommendations.

Any disclosure of interest that may influence any research or recommendation needs to be specific to the subject corporate issuer and meaningful, not just standard boilerplate phrasing. Jargon and unnecessary abbreviations should be avoided. Disclosure should be reasonable and adequate for the circumstances and specific to the research subject, rather than generic in nature, to enable investors to clearly understand those particular matters of significance to the subject corporate issuer.

Disclosures should be prominent, not hidden in small print, with adequate notification of their existence and location in the research report.

5. Dissemination of Research

Principle:

Research reports and recommendations should be disseminated to clients in a timely manner. Notification of any subsequent significant changes, corrections, amendments or updates to published research should also be promptly distributed.

Commentary and guidance:

Analysts and their broking firm should ensure that research reports and recommendations intended for publication are issued or made public only through the normal distribution channels (including mail distribution, electronic media or agency agreement).

Before publication and dissemination to clients, an analyst may only forward a draft research report to the corporate issuer covered in the research subject to two strict conditions:

- (i) that the draft research report is provided to the subject corporate issuer for the sole limited purpose of checking or verifying facts contained in the research report – not for their review or approval; and
- (ii) that the proposed investment recommendation or price target has been deleted or removed from the draft copy forwarded to the subject company.

If this checking or verification process reveals that a change needs to be made to the research report, the analyst should keep a proper record of the change and outline the specific reasons for the particular change.

ASAF Position Paper
Addressing Conflicts of Interest in Securities Analyst Research

6. Restrictions on Personal Account Dealing and Trading by Analyst

Principle:

To enhance research objectivity and avoid potential conflicts of interest, stockbroking firms should have explicit policies on analysts trading in place and should impose specific restrictions and limitations on personal dealings by analysts in the securities or sectors that their research activities cover.

Commentary and guidance:

It is thought that where an analyst has a shareholding or financial interest in the particular securities or sectors that they cover in their research, this beneficial interest may influence the content of the research, in particular the conclusions and recommendations.

Such trading restrictions should be designed to ensure that analysts and their firm do not exploit their position and use knowledge of the content of a research report and timing of its publication to inform their own personal/proprietary dealing and thereby put their own interests above those of their clients.

The extent to which an individual analyst is permitted to deal on their own personal account or on behalf of others will be subject to their firm's internal policy on personal account dealing and trading. In practice, a firm's policy may either prohibit their analysts from dealing in the securities of the companies they cover (and possibly extend this to securities of other companies in the same sector) or may just impose a maximum limit on an analyst's personal account holdings or dealings in a specified issuer's stock. In addition, a firm's policy may permit an individual analyst to trade in a security covered in the analyst's research in exceptional circumstances, such as when the analyst has made application and obtained prior approval from research management and compliance.

Dealing or trading ahead of the issue of research (front-running) should be strictly prohibited. Broking firms that employ analysts and issue securities research reports or recommendations should have an internal policy in place that prohibits trading of subject securities ahead of publishing research on the issuer of those securities and sets out restricted periods of trading prohibition before and after issue of a research report or recommendation.

The timing of any personal account dealing or trading in a security covered in a research report prepared by an analyst and issued by the firm is relevant.

The following policy approach is recommended best practice for broking firms and analysts:

- While in the process of preparing research on a particular corporate issuer, an analyst should not be permitted to trade in the securities of that subject issuer.
- An analyst should not be permitted to trade in a security covered in a research report they prepared ahead of publication of the research on the subject issuer of the securities.
- An analyst should not be permitted to trade in a security covered in a research report they prepared for a reasonable period after publication of the research, at least until the firm's clients have had an adequate opportunity to act on the analyst's research and recommendations as determined by the analyst's broking firm.
- An analyst should not be permitted to trade in a manner inconsistent with their research reports or recommendations published.

An analyst should not step around the stockbroking firm's controls on analyst personal account dealings by disclosing their research recommendations before publication to any other parties and encouraging such other parties to deal either on their own account or on the analyst's behalf.

If during the research process a research analyst obtains some material price-sensitive information about the subject issuer that is not public information, either

- (a) as a result of a special or confidential relationship or as a result of selective disclosure, or
- (b) if the analyst is not in a special or confidential relationship but knows or should have known that the information was misappropriated or that disclosure would result in a breach of duty,

ASAF Position Paper
Addressing Conflicts of Interest in Securities Analyst Research

then the analyst should not use or act on such information for their own personal benefit or otherwise disseminate or communicate it to others. If appropriate, the analyst should instead encourage the subject issuer to make public disclosure of the material information to the market.

7. External Pressure from Issuer

Principle:

Each stockbroking firm should have in place a clear policy that expressly prohibits any analyst or other staff member from accepting an inducement to produce favorable research on a subject corporate issuer, in order to retain or secure any business or information.

Commentary and guidance:

An analyst should be particularly mindful of any improper influence or pressure exerted by a corporate issuer whose securities are the subject of a research report or recommendation. In particular, an analyst should be wary of measures calculated to influence their independent professional judgment and research by making access to company information conditional on the production of a favorable report or recommendation.

Therefore, in any direct communications with management of the subject corporate issuer, an analyst should take care that the subject issuer does not exert effective control over the final content of the research report or recommendation published or does not improperly influence or compromise their judgment or objectivity.

A firm should have a policy in place for dealing with any subject corporate issuer who may attempt to improperly influence an analyst's issued research report or recommendation or seek to retaliate against or exert pressure on the analyst or the firm's management on disagreeing with or disputing the analyst's research or recommendation.